TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 99-20

WARNING

Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.

SUBJECT

The application of sales and use tax to in-process tanks used in the taxpayer's manufacturing operation.

SCOPE

Revenue rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue rulings are advisory in nature and are not binding on the Department.

FACTS

The taxpayer manufactures [PRODUCT]. The finished product is made-to-order for each customer. The manufacturing process can be divided into two sub-processes: a reactor process and a blending process.

In the reactor process, certain chemicals are charged to the reactor where heat is applied to initiate a chemical reaction creating [MATERIAL A]. After the reactor has cooled down to a prescribed temperature, [MATERIAL A] is transferred to a thinning tank where [MATERIAL A] is dissolved in [CHEMICAL], and inhibitors are added to produce [MATERIAL B]. [CHEMICAL] and inhibitors are necessary to stabilize and keep [MATERIAL B] in a "transportable, liquid form." If [MATERIAL A] cooled to room temperature without being dissolved in [CHEMICAL] and without the addition of inhibitors, [MATERIAL A] would become solid.

Once [MATERIAL B] meets the defined quality specification, it is either pumped to a blending tank or to an in-process tank. In a majority of cases the entire amount is pumped directly to an in-process tank. In those cases where [MATERIAL B] is sent directly to the blending tank, usually a portion will have to be pumped to an in-process tank because the capacity of the blending tanks (after additional raw materials are added for the blending process) is less than the reactor's capacity. Approximately seventy to eighty percent of [MATERIAL B] goes through the in-process tanks.

The in-process tank helps to maintain the temperature and consistency necessary to begin the blending process. However, it does not actually heat or cool [MATERIAL B]. Nor does it mix or stir [MATERIAL B]. [MATERIAL B] may remain in the in-process tank up to three days or only for a few hours. On average, [MATERIAL B] stays in the tank between eight and twenty-four hours. This quick turnover along with the [CHEMICAL] and inhibitors added in the reactor process prevent the liquid from solidifying. In-process tanks allow the reactor to produce more [MATERIAL B] than the blending tanks can hold. Consequently, the reactor has to be shut down very infrequently. Because the taxpayer is a made-to-order manufacturer, it would not be able to meet the required delivery times established by its customers without the use of in-process tanks.

In the blending process, [MATERIAL B] will be pumped from in-process tanks to an available blending tank. At this point, other chemicals are added and blended into [MATERIAL B] based upon customer specifications. In many cases, [CHEMICAL] is also added and high shear mixing is applied to the batch. Once the blending process is completed, [PRODUCT] is tested by the quality lab to ensure that the product meets customer specifications. The product is then loaded and shipped to the customer. In very few cases, [MATERIAL B] is supplied to certain customers without modification. In these cases, however, [MATERIAL B] is first pumped into an available blending tank. [MATERIAL B] is then tested by the quality lab to ensure that it meets the defined quality specifications, and any necessary adjustments are made. The chemicals added during the blending process give finished [PRODUCT] the ability to gel and maintain a certain viscosity (based on customer specifications) once a catalyst is added to the finished [PRODUCT]. The customer will apply a catalyst to the finished [PRODUCT] which will result in a chemical reaction causing it to gel and harden.

The taxpayer is principally engaged in the fabrication of these [PRODUCTS] for resale to others for use and consumption off the premises of the taxpayer. Accordingly, the taxpayer possesses a valid industrial machinery authorization number issued by the Department. The in-process tanks are used exclusively for in-process [MATERIAL B]. No raw materials or finished products are stored in these tanks.

The taxpayer is in the process of installing a new reactor which will increase the plant's current capacity by more than 60%. As a result, the purchase and installation of additional in-process tanks will be necessary.

ISSUE

Whether in-process tanks, as described in the facts, are exempt from sales and use tax as industrial machinery.

RULING

The in-process tanks do qualify as industrial machinery exempt from sales and use tax.

ANALYSIS

T.C.A. § 67-6-206(a) provides to manufacturers an exemption with respect to industrial machinery, defined in part as follows:

> (A) Machinery, apparatus and equipment with all associated parts, appurtenances and accessories, including hydraulic fluids, lubricating oils, and greases necessary for operation and maintenance, repair parts and any necessary repair or taxable installation labor therefor, which is necessary to, and primarily for the fabrication or processing of tangible personal property for resale and consumption off the premises. . .where the use of such machinery, equipment or facilities is by one who engages in such fabrication or processing as one's principal business. . .

T.C.A. § 67-6-102(13)(A).

This definition contains four requirements which must be met in order for the in-process tanks to be exempt as industrial machinery. First, the taxpayer must be a manufacturer. Second, the in-process tanks must be machinery, apparatus or equipment. Third, the in-process tanks must be necessary to the fabrication of the product to be sold. Fourth, the in-process tanks must be used primarily for the fabrication of the product to be sold.

Under the facts presented it is clear that the taxpayer qualifies as a manufacturer. The facts provide that the taxpayer is principally engaged in the fabrication of [PRODUCTS] which are sold to others for use and consumption off the premises. Furthermore, the facts provide that the taxpayer possesses a valid industrial machinery authorization number issued by the Department. The taxpayer is therefore a manufacturer entitled to the exemption provided in T.C.A. § 67-6-206(a).

The second requirement also is satisfied. The tanks used by the taxpayer clearly qualify as machinery, apparatus, or equipment under the definitions of these terms set out by the Supreme Court in *Tibbals Flooring Company v. Huddleston*, 891 S.W.2d 196, 198-199 (Tenn. 1994), and *AFG Industries, Inc. v. Cardwell*, 835 S.W.2d 583, 585 (Tenn. 1992).

With respect to the third requirement, the Department looks at whether the item in question is necessary to the production process as engaged in by the taxpayer. In doing so, the Department looks at the entire manufacturing operation as it is commonly understood, including all items which make up an integrated system of production.

However, the statutory definition of industrial machinery also places limits upon what items constitute the manufacturing operation. The statute provides:

> (D) Such industrial machinery necessary to and primarily for the fabrication and processing of tangible personal property for resale or used primarily for the control of air pollution or water pollution includes, but is not limited to:
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> (i). . .
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> (ii) Equipment used in transporting raw materials from storage to the manufacturing process, and transporting finished goods from the end of the manufacturing process to storage;
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>
> (F) Such industrial machinery necessary to and primarily for the fabrication or processing of tangible personal property for resale and consumption off the premises or used primarily for the control of air pollution or water pollution does not include machinery, apparatus and equipment used prior to or after equipment exempted by subdivision (13)(D)(ii). . .

T.C.A. § 67-6-102(13)(D)(ii) and (F). Thus, the manufacturing operation does not include machinery, apparatus, or equipment used before raw materials are introduced to the process nor that which is used after the finished goods have been shipped from the manufacturing process to storage. *See Nuclear Fuel Services, Inc. v. Huddleston*, 920 S.W.2d 659, 662 (Tenn. Ct. App. 1995), *perm. app. denied* (1996). In addition, court decisions in Tennessee make it clear that storage by itself is not considered manufacturing. *The Beare Company v. Tennessee Department of Revenue*, 858 S.W.2d 906, 908 (Tenn. 1993) (citing *Woods v. General Oils, Inc.*, 558 S.W.2d 433, 436 (Tenn. 1977)). The Tennessee Supreme Court has expressly recognized that there is a distinction between fabricating or processing and storage. *Id*.

The facts make it clear that the taxpayer's in-process tanks are necessary to the taxpayer's operation. They allow the reactor to remain in almost continual operation and make it possible for the taxpayer to provide made-to-order products in a timely manner. Therefore, the determinative question is whether the taxpayer's in-process tanks fall within the boundaries set by T.C.A. § 67-6-102(13)(D)(ii) and (F).

Under the facts provided, the manufacturing process consists of two sub-processes: a reactor process and a blending process. The in-process tanks hold [MATERIAL B] which have been produced in the reactor process until they can be used in the blending process. The tanks help maintain the temperature and consistency necessary to begin the blending process. However, they do not actually heat, cool, or otherwise change [MATERIAL B]. Nor do they mix or stir [MATERIAL B]. [MATERIAL B] may remain in the in-process tank anywhere from a few hours up to three days. On average, [MATERIAL B] stays in the tank between eight and twenty-four hours.

Certainly many manufacturing operations consist of various processes with the product being held for short amounts of time between certain processes. This could occur where the product is held temporarily until there is sufficient space for it in the next process. In those cases the product is never removed from the manufacturing process as contemplated by T.C.A. § 67-6-102(13)(D)(ii) and (F), and the equipment used to hold the product is part of the manufacturing operation. On the other hand, in some cases when one process is finished the product is actually removed from the manufacturing operation and put in storage for a period of time. The product is later removed from storage and returned to the manufacturing operation for further fabrication or processing. The equipment used for storage in those cases is excluded from the definition of industrial machinery under T.C.A. § 67-6-102(13)(D)(ii) and (F).

While the in-process tanks at issue here present a close question, based on the particular facts provided the tanks are part of the manufacturing process. [MATERIAL B] is held in the in-process tanks until there is space for it in the blending process. Although they do not actually heat [MATERIAL B], the tanks help maintain its temperature and consistency. On average [MATERIAL B] stays in the tanks only for eight to twenty-four hours and would solidify if it stayed in the tanks for more than three days. Consequently, it is concluded that [MATERIAL B] is not removed from the manufacturing process for storage and later use. Therefore, the tanks are part of the taxpayer's production process.

The final requirement is that the tanks be used primarily for the fabrication or processing of the product to be sold. The word "primarily" has been defined by the Tennessee Supreme Court as "first of all; principally; or fundamentally" and as "first in rank or importance, chief, principal, basic or fundamental." *Woods v. General Oils, Inc.*, 558 S.W.2d 433, 436 (Tenn. 1977). The machinery, equipment, or apparatus satisfies this test if at least fifty-one percent of its use is in the manufacturing operation. The tanks at issue are used for only one purpose which has been determined to constitute part of the manufacturing process. Thus, the final requirement is also satisfied.

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APPROVED: Ruth E. Johnson, Commissioner

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